Punch

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A BOUTIQUE INVESTMENT ADVISORY

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Time is on My Side

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"The U.S. stock market was now a class system, rooted in speed, of haves and have-nots. The haves paid for nanoseconds; the have-nots had no idea that a nanosecond had value." — Michael Lewis, Flash Boys

About this time last year, business author Michael Lewis released a controversial new book titled, Flash Boys, in which he called the U.S. stock market "rigged" and claimed that ordinary investors were getting "screwed" by a relatively new type of investing called high-frequency trading. High-frequency trading (HFT) is the use by certain trading firms of advanced technologies ultra high speed internet connections and sophisticated mathematical algorithms—to gain an ever-so-slight advantage over other investors in executing orders over stock exchanges. In some cases, the exchanges themselves were even aiding these HFT operations and benefiting from them.

The story, while almost certainly sensationalized for publication, does paint an unattractive picture of investing today, where advantages lie in the fastest computers and the smartest algorithms; where profit comes from inside information on others' trading activities; and where established institutions like the NYSE pander to these market manipulators. From this vantage point, investing is boiled down to its crudest form and investing time horizons are shrunk to almost immeasurably short periods.

We wholeheartedly agree that HFT is the moral equivalent of insider trading and that there is little to no value in the existence of such firms. What is almost worse, though, is that HFT strategies help to create the idea that, to be a successful investor, you need a degree from MIT and thousands of dollars' worth of technology. We feel this could not be further from the truth. Warren Buffett, the world's best investor, famously does not have a computer in his office and does not use email. Most of his time, he says, is simply spent reading and thinking.

Successful investing requires common sense and intelligence, but not brilliance. Most of all, it requires patience. After all, an owner of stock is a fractional owner of a real business. While stock prices may swing from minute-to-minute or month-to-month for random or unpredictable reasons, the biggest determinant of stock prices over a significant period of time is the *performance of the business itself*. High-frequency traders may have an advantage in the world of microseconds, but they are certainly nowhere to be found in the world of years and decades.

In the Punch Small Cap Strategy, we consider ourselves to be owners of businesses, not merely owners of stocks to be traded quickly and haphazardly. We spend our time learning about businesses, analyzing them and interviewing the people running them, so that we can make some determination of their likely success or failure in the years to come. We don't go to these lengths so that we can execute a trade a microsecond ahead of other investors and then trade it again a microsecond later. We believe such mindless trading at the expense of others is, in short, idiotic.

Of the 47 holdings in the Punch Small Cap Strategy today, half have been held for longer than three years. Nearly one-quarter have been held for longer than five years, and three stocks have been in the portfolio for a decade, having been purchased in 2005. If we have done our job well, the longer we own growing, profitable businesses, the longer we benefit from their compounding abilities.

To correct Michael Lewis: there is no value in a nanosecond.

Howard